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(U) This cable is sensitive but unclassified. Please treat accordingly.

¶1. (SBU) Summary: Although the domestic banking system has remained relatively healthy, the small, open, export-oriented Czech economy is suffering from a significant drop in external demand for Czech exports. According to recently released figures, exports fell a record 18 percent, industrial production 17.4 percent and retail sales 6.3 percent year on year in November, while unemployment rose 0.7 percentage points to 6 percent in December. The car industry, which together with its suppliers accounts for as much as 20 percent of Czech manufacturing, has been especially hard hit. Many analysts now expect the Czech economy to stagnate in 2009, with possible negative growth in the first two quarters. The European Commission and Finance Ministry, however, continue to expect modest growth of 1.7 and 1.4 percent respectively.

¶2. (SBU) PM Topolanek created a ten person national economic council on January 8 to advise the government on an appropriate response to the economic slow down. Analysts note that since the economyQs main challenge is a drop in external demand, domestic remedies, such as a fiscal stimulus, can only help at the margins. While some modest measures are likely, including additional interest rate cuts, more state export guarantees, and cuts in employee contributions to social programs, Finance Minister Kalousek opposes any measures that would significantly increase the Czech RepublicQs modest budget deficit. Kalousek also intends to bring his fiscal discipline zeal to EU and G-20 discussions on responding to the global financial crisis. The European Commission is representing the Czech EU presidency in the G-20 working groups but the Czechs plans to participate actively in the senior-level discussions. End Summary.

Czech Financial System Remains Relatively Healthy

¶3. (SBU) Despite the global financial crisis, Czech banks have remained relatively healthy. The Czech Republic experienced a significant financial crisis from 1997-2002 that cost around 20-30 percent of GDP to fix. The result was the consolidation of the banking market, the removal

of non-performing debts from balance sheets and fairly conservative banks and consumers. Czech banks are not heavily leveraged, focused almost exclusively on the domestic market, and have largely eschewed complicated opaque investment vehicles in favor of domestic lending. Lending is financed by deposits; the Czech banking systemQs average loan to deposit ratio is less than 75 percent (Ref B).

¶4. (SBU) The Czech RepublicQs largest bank, CSOB, has been hardest hit by the global crisis, but despite writing off over 12 billion Czech crowns (approximately USD 600 million) of collaterized debt obligations (CDOs) and exposure to Icelandic banks, remained profitable in ¶2008. At the beginning of 2009, CSOB had a capital adequacy of over 10 percent and a loan to deposit ratio of 70 percent. The other major banks have fared significantly better. The second largest bank, Ceska Sporitelna, reported a return on equity of 22.5 percent and an increase in net profits of 21 percent for the first three quarters of 2008. The third largest, Komercni Bank, reported an increase in net profits of 22 percent during the same period.

¶5. (SBU) The Czech Republic has not experienced a financial crisis in 2008-09, maintains Unicredit Bank Chief Analyst Pavel Sobisek. While a couple of banks had temporary liquidity problems in 2008, the Czech National Bank (CNB) reacted quickly to prevent any serious problems from emerging. He conceded that the interbank lending market is not functioning, as banks do not trust one another, but argued that this has not been a problem,

as banks can easily borrow what they need from the CNB. According to Finance Minister Kalousek, the Czech Republic is only one of three OECD countries that has not had to inject capital into its banking sector.

¶6. (SBU) Unicredit Bank Chief Analyst Sobisek also maintained that the Czech Republic is not experiencing a credit crunch. Statistics, he argued, show that the volume of bank loans has continued to increase, albeit at a much slower rate than before. He did admit that many banks have tightened their loan criteria and are reluctant to lend to certain sectors such as to real estate developers. Fewer companies, however, are also seeking credit as they have decided to postpone new investments until better times. Others, however, argue that while credit is still available to large customers, credit has become much more difficult and expensive for small and medium enterprises to obtain. According to a Chamber of Industry survey, two thirds of companies reported that credit is now more scarce. Latest estimates show a 20 percent decline in the volume of new mortgages in 2008.

Real Economy Suffering from Drop in Demand for Exports

¶7. (SBU) While Czech banks remain relatively healthy, the Czech real economy is suffering from a significant drop in demand in Western Europe for Czech products. As an open, export-oriented economy, the Czech Republic is especially sensitive to economic slow-downs in its main trading partners. The annual volume of Czech exports exceeds 80 percent of the Czech RepublicQs GDP. Over 80 percent of Czech exports go to other EU member states. Over 30 percent of total exports go to Germany alone. According to Ceska Sporitelna Bank analysts, for every percentage point drop in German GDP growth, Czech GDP growth drops by roughly 0.4 percentage points.

¶8. (SBU) The Czech Statistical Office recently released figures for November showing a record year on year drop in exports (18 percent), industrial production (17.4 percent) and the value of new industrial orders (30.2

percent). Retail sales also fell 6.3 percent. Unemployment increased 0.7 percentage points to 6 percent in December (although is still well below the December 2006 level of 7.7 percent). While these numbers were partly inflated due to fewer working days this November than last, the drop was much more severe than anyone expected, causing many analysts to further revise their growth forecasts for the fourth quarter of 2008 and for all of 2009 downward. While the European Commission and Finance Ministry continue to forecast modest growth in 2009 of 1.6 and 1.4 percent, respectively, many private analysts now expect the Czech economy to stagnate, with possible negative growth in the first two quarters.

¶9. (SBU) The Czech economy has been helped by the fact that it entered into late 2008 in strong shape. Real economic growth had exceeded 6 percent annually from 2005-2007 and remained above 4.2 percent year on year for each of the first three quarters of 2008. Unemployment hit record lows in July of 5.2 percent (4.3 percent using EU counting methods), leading many businesses to view a shortage of labor as the largest constraint to continued strong economic growth. To fill the gap, Czechs imported thousands of laborers from abroad, including from Ukraine, Vietnam and Mongolia. The Czech national debt is roughly 30 percent of GDP and private indebtedness is also relatively low.

¶10. (SBU) Nevertheless, a few industries have been especially hard hit. Several large historic firms in the Czech crystal and ceramic industry, which had been struggling for some time, have now closed or filed for bankruptcy, sending several thousand people out of work. Four and five star hotels in Prague are reporting occupancy rates down 30 percent on 2007 levels since summer 2008. The car industry, which had until recently been flourishing, grew only 1 percent for the year after expanding by as much 9.5 percent during the first three quarters. The Czech Republic is the second largest producer of cars per capita in the world and the car industry accounts for as much as 20 percent of manufacturing. All major vehicle manufacturers have cut production by as much 25 percent, laid off most non-

contract workers and implemented a four day work week. The automobile industry association is predicting that by summer, car manufacturers and their suppliers will have let go 13,500 of the industryQs roughly 130,000 employees. Skoda AutoQs External Relations Director Radek Spicar told us that the current situation was unique in that none of their export markets was immune from the crisis. As a result demand for their product was falling not only in Western Europe, but in Russia, Ukraine, India, and Asia as a whole.

Government Considering Modest Steps; Worried about Public Finances

¶12. (SBU) The Czech National Bank (CNB) has responded aggressively to the financial crisis, lowering its two week repo rate by 75 basis points (bp) on November 7 and by 50 bp on December 18. Since inflationary pressures are no longer a concern (inflation is currently 3.6 percent and projected to fall below 2 percent by the end of the year), the market widely expects another 50 bp cut at the CNBQs next meeting in early February. The CNB has also acted to provide liquidity into the banking and government bond sectors by enabling banks to borrow money directly from the CNB using government bonds as collateral.

¶13. (SBU) With the exception of the Czech National Bank (CNB), however, the governmentQs response to the economic slowdown has so far been very modest. On January 1, mandatory employee contributions to social programs were

cut by 1.5 percentage points and a small government subsidy was offered to people under 36 buying a home. Both of these actions, however, were planned independently of the crisis. The government also made available an additional 3 billion crowns (USD 150 million) in capital to the state-owned Czech Export Bank and Czech-Moravian Guarantee and Development Bank to allow them to increase export guarantees and corporate lending. Finance Minister Kalousek has repeatedly said that the government would take concerted steps to address the crisis only if Czech economic growth slowed to less than 2 percent. Now that it is clear that this condition is being met, the government is scrambling to assemble a package of crisis measures.

¶14. (SBU) After being unable to find anyone willing to accept the proposed position of Deputy PM for Economic Affairs, PM Topolanek announced January 8 the creation of a 10-member National Economic Council, charged with advising the government on an appropriate response to the economic slow down. The Council consists of prominent economists and representatives of the banking and car industries. The opposition CSSD has refused to participate in the Council in a move that is widely being interpreted as an attempt to avoid being seen as sharing political responsibility for economic slow down. CSSD has presented its own proposals, which would be partially financed by increasing taxes on the wealthy.

¶15. (SBU) The Council met with key Government Ministers January 25. According to PM Topolanek, the Council considered over 250 possible measures and gave priority to accelerating depreciation of business assets (including cars) lowering of social insurance contributions for new or recently retrained employees, providing state guarantees for corporate loans, and increasing government spending on research, education, the environment, infrastructure and some regional projects. The Council and government are now preparing concrete measures for inclusion in a crisis response package that will be submitted to parliament in February. A press conference has been tentatively planned for February 15.

¶16. (SBU) Council Member and CSOB Chief Macroeconomic Strategist Tomas Sedlacek reported that the Council had agreed that the governmentQs basic priority should be to help Czech exporters rather than to try to stimulate domestic demand. Another Council member stressed to us that it will be very difficult for the government to address the economyQs main challenge (i.e., the drop in external demand), although he noted other countries stimulus packages will also help the Czech Republic. Former Industry/Economic Minister and Council member

Vladimir Dlouhy noted that domestic demand had fallen in November, but preliminary data for December suggested that the Czechs had not cut back on Christmas spending. He too noted that since the Czech Republic was a small open economy, any government actions would only help on the margins. Nevertheless, he advocated for a government fund designed to help SMEs get better access to credit at more affordable rates.

¶17. (SBU) On January 26, Finance Minister Kalousek introduced a revised budget with projected revenues based on one percent growth. In December, the Parliament had passed the original 2009 state budget -- which was based on the unrealistic assumption of 4.8 percent growth -- with the caveat that it would have to be revised in early ¶2009. The newly revised budget makes only a few cuts and increases revenues mainly by forcing each ministry to tap into its reserve fund (i.e., unspent funds left over from previous fiscal years). The newly revised budget envisions a budget deficit of 73.3 billion crowns (or

roughly 2 percent of GDP).

¶18. (SBU) The revised budget, however, does not include any of the new crisis response measures under consideration by the Council. Council member Michal Mejstrik reported that the Council still did not know the level of funding the government was willing to devote to the proposed measures. Kalousek, who has the reputation as a strong fiscal conservative, has stressed that he will do all in his power to prevent the budget from ballooning, noting that in a period when all governments are borrowing heavily, he was concerned that the government bond market could burst. Given the right-of-center political orientation of the current government, as well as PM TopolanekQs strong support for Kalousek, few analysts expect the government to put forward more than a few relatively inexpensive crisis response measures.

Czech EU Presidency Response: Stressing Fiscal Discipline

¶19. (SBU) Czech Finance Ministry officials have told us that coordinating the EU response to the global financial crisis is the MinistryQs main priority for the Czech EU Presidency. Ministry officials have been having regular meetings with UK finance officials to coordinate Czech actions. While our working level contacts have stressed the PresidencyQs responsibility to act as an honest broker, Minister Kalousek told Ambassador Graber January 14 that he planned to interject three principles into EU discussions:

The need for fiscal discipline. The Stability and Growth Pact was not just for good times;

The need for fair economic competition and resisting beggar they neighbor actions; and

The need for transparency. The rationale for, and costs of, all measures should be presented to the public clearly. One should not argue in favor of subsidies for new cars based on environmental grounds when the real purpose it to support the car industry.

¶20. (SBU) Kalousek told the Ambassador that he viewed the financial crisis as primarily a problem of confidence and thus did not believe that a large fiscal stimulus was the answer. He also raised long term concerns about the financing of debt, noting that even Germany was having problems selling government bonds.

¶21. (SBU) Finance Ministry EU Department Head Drahomira Vaskova told us that the European Commission is representing the Czech EU Presidency in the G-20 Working Groups, and that the main document for the EU Economic and Financial Committee will also be prepared by the Commission. The Czechs, however, plan to actively participate in the political level meetings. The Czechs are planning an informal ECOFIN meeting (meeting of EU member state Finance Ministers) for Prague on April 3-4. The main topics for discussion will be an assessment of the economic and financial impact of the 2004 EU enlargement and a discussion of the recommendations of the Larosiere High-Level Group on financial supervision. The Czechs are also considering inviting Treasury

Secretary Geithner to participate in a working lunch with his EU Member State counterparts on the global financial crisis. Other priorities for the Czech Presidency include preventing Qthe spread of protectionism and undue state intervention,Q implementation of the European Economic Recovery Plan, the review of the EU directive on capital adequacy of investment firms and credit institutions, negotiations on the EU directive regulating the insurance sector, the regulation on credit rating

agencies, and the directive on electronic money institutions, as well as modernizing rules for applying VAT to financial and insurance services.

Comment

¶22. (SBU) The current Czech government is very fiscally conservative and skeptical of pan-European regulations and increased government involvement in the economy. This world view is informing its actions both domestically and internationally. Although the Czech economy may contract in 2009, we do not anticipate a significant Czech fiscal stimulus program or any bail outs of key Czech industries. With it low government debt, commitment to maintain fiscal discipline, still relatively strong currency, and low current account deficit (-2.3 percent on a yearly basis for the third quarter in 2008) the Czech Republic is unlikely to experience some of the same problems faced by other countries in the region. Although the business community continues to lobby for the rapid adoption of the Euro, the crisis has done nothing to change the current governmentQs (mainly ideological) reluctance to adopt the common currency anytime soon. PM Topolanek again postponed a decision on a target date until November and suggested that even a goal of 2013 or 2014 was far from assured.

Thompson-Jones